

## Message Text

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PAGE 01 OECD P 15139 01 OF 03 121417Z

44

ACTION EUR-12

INFO OCT-01 ISO-00 EURE-00 SSO-00 NSCE-00 INRE-00 AID-05

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IO-10 NEA-10 NSAE-00 OPIC-03 SP-02 TRSE-00 CIEP-01

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PASS CEA FOR MACAVOY, FRB FOR SOLOMON, TREASURY FOR  
WIDMAN

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TAGS: ECON, OECD

SUBJECT: PREVIEW OF EDRC ANNUAL REVIEW OF U.S.

REF: OECD DOCUMENT EDR(75)14

1. SUMMARY: SECRETARIAT DRAFT SURVEY OF U.S. FORECASTS  
UPTURN OF REAL DEMAND AND OUTPUT IN SECOND HALF OF 1975,  
BUT CAUTIONS THAT RECOVERY MAY LOSE MOMENTUM IN COURSE  
OF 1976. UNEMPLOYMENT RATE UNLIKELY FALL BELOW 9 PERCENT  
BEFORE MID-1976. SOME FURTHER MODERATION OF INFLATION  
CAN BE EXPECTED, BUT PROBABLY NOT BEYOND END OF YEAR.  
CURRENT ACCOUNT BALANCE FORECAST AT \$3.5 BILLION SURPLUS FOR  
FULL YEAR 1975. SECRETARIAT RECOMMENDS THAT IN VIEW OF  
DELICATE BALANCE BETWEEN INFLATION AND UNEMPLOYMENT,  
ECONOMIC POLICY SHOULD AIM AT MORE MODERATE RECOVERY  
THAN IN PAST BUSINESS CYCLES. SECRETARIAT EXPRESSES  
SOME CONCERN ABOUT MONETARY GROWTH TARGETS, WHICH IT  
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PAGE 02 OECD P 15139 01 OF 03 121417Z

THINKS MAY NOT BE HIGH ENOUGH (ESPECIALLY M-1) TO

ABSORB DEBT OBLIGATIONS ISSUED BY TREASURY AND TO SATISFY CREDIT DEMANDS ASSOCIATED WITH EXPECTED RECOVERY OF ECONOMY. ON FISCAL SIDE, SECRETARIAT BELIEVES THERE IS LITTLE SCOPE FOR FURTHER TAX REDUCTIONS, AND THAT SELECTIVE INCREASES IN EMPLOYMENT-CREATING PUBLIC EXPENDITURES WOULD BE PREFERABLE. DRAFT SURVEY TAKES OPPORTUNITY TO RE-EMPHASIZE THAT RECOVERY OF ACTIVITY IN U.S. IS ESSENTIAL FOR ECONOMIC WELL-BEING OF REST OF OECD AREA. MAIN ISSUES FOR DISCUSSION ARE SUMMARIZED IN PARA 7 BELOW. END SUMMARY.

2. OUTPUT AND DEMAND: SECRETARIAT FORECASTS UPSWING IN ECONOMIC ACTIVITY TO DEVELOP IN SECOND HALF OF YEAR, WITH REAL GNP IN 1975-II GROWING AT ANNUAL 4.7 PERCENT RATE. SECRETARIAT EXPECTS RECOVERY OF ACTIVITY TO BE LED BY PRIVATE CONSUMPTION AND RESIDENTIAL CONSTRUCTION BEGINNING IN THIRD QUARTER. IT SEES CONSUMPTION RESPONDING TO IMPETUS OF TAX CUT, IMPROVED REAL INCOMES (DUE TO SLOWER GROWTH OF CONSUMER PRICES COMBINED WITH STEADY ADVANCES IN WAGE RATES), AND STABILIZATION OF EMPLOYMENT SITUATION. RESIDENTIAL CONSTRUCTION CAN BE EXPECTED TO RESPOND TO REDUCTION IN HOUSING STOCK AND FALLING MORTGAGE RATES, ALTHOUGH RECOVERY MAY BE MORE MODERATE THAN DURING PREVIOUS UPSWINGS. NON-RESIDENTIAL FIXED INVESTMENT IS LIKELY TO REMAIN DEPRESSED THROUGHOUT FORECAST PERIOD, AS INVENTORY DECUMULATION PROCEEDS DURING REMAINDER OF YEAR. GOVERNMENT SPENDING IS FORECAST TO SHOW ONLY SLIGHT INCREASES IN REAL TERMS OVER NEXT FISCAL YEAR.

3. PRICES AND WAGES: SECRETARIAT SEES FURTHER MODERATION OF INFLATION IN NEAR FUTURE BUT DOES NOT EXPECT RETURN TO RELATIVE PRICE STABILITY OF 1960'S. CURRENT PACE OF DIMINISHING INFLATION MAY NOT CONTINUE INTO 1976, AS WAGE PRESSURES PERSIST AND RECENT DECLINES IN RAW MATERIAL PRICES TURN AROUND IN RESPONSE TO EXPECTED

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PAGE 01 OECD P 15139 02 OF 03 121424Z

44

ACTION EUR-12

INFO OCT-01 ISO-00 EURE-00 SSO-00 NSCE-00 INRE-00 AID-05

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LIMITED OFFICIAL USE SECTION 02 OF 03 OECD PARIS 15139

RECOVERY OF DEMAND. HOWEVER, SECRETARIAT DOES RECOGNIZE THAT PROSPECTS FOR LARGE AGRICULTURAL HARVESTS MAY TEND TO STABILIZE FOOD PRICES, AND THAT WAGE PRESSURES WILL BE HELD IN CHECK BY CONTINUING HIGH RATES OF UNEMPLOYMENT, WHILE UNIT LABOR COSTS ARE DAMPENED BY INCREASES IN PRODUCTIVITY DURING INITIAL STAGES OF RECOVERY.

4. POLICY STANCE: SECRETARIAT CONCLUSIONS ARE WELL BALANCED WITH REGARD TO INFLATION/UNEMPLOYMENT TRADE-OFFS. THEY NOTE THAT MORE VIGOROUS RECOVERY MIGHT HAVE BEEN DESIRABLE FROM POINT OF VIEW OF REDUCING UNEMPLOYMENT AND BOOSTING DEMAND FOR IMPORTS, BUT THEY RECOGNIZE THAT AVOIDING RESURGENCE OF INFLATIONARY PRESSURES IS EQUALLY IMPORTANT FROM BOTH NATIONAL AND INTERNATIONAL POINT OF VIEW. SECRETARIAT THINKS, THEREFORE, THAT IT MAY BE ADVISABLE TO AIM AT MORE MODERATE RECOVERY THAN TYPICAL OF PREVIOUS BUSINESS CYCLES. IT CAUTIONS THAT IT WOULD BE IMPRUDENT TO ALLOW RISE IN INTEREST RATES AT EARLY LIMITED OFFICIAL USE

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PAGE 02 OECD P 15139 02 OF 03 121424Z

STAGE OF RECOVERY, AND SUGGESTS THAT SOME ADJUSTMENT OF MONETARY TARGETS ANNOUNCED BY FRB MAY PROVE NECESSARY. IN PARTICULAR, IT CONSIDERS THAT TARGET RANGE OF GROWTH OF M-1 MAY BE TOO LOW AT 5-7.5 PERCENT TO BE CONSISTENT WITH EXPANSION OF ECONOMY NEEDED TO BRING DOWN LEVEL OF UNEMPLOYMENT. STRICT ADHERENCE TO THIS TARGET COMBINED WITH TREASURY FINANCING OF DEFICIT AROUND \$70 BILLION COULD WELL ENTAIL RISING INTEREST RATES WHICH MIGHT SLOW DOWN RATE OF EXPANSION. REFDOC DEVOTES CHAPTER TO PROBLEMS OF FINANCING FEDERAL BUDGET DEFICIT AND CONCLUDES THAT, WITH APPROPRIATE DEBT MANAGEMENT

AND ADEQUATELY EXPANSIVE MONETARY POLICY, IT SHOULD BE POSSIBLE BOTH TO ABSORB DEBT OBLIGATIONS ISSUED BY TREASURY IN 1975 AND TO SATISFY CREDIT DEMANDS ASSOCIATED WITH EXPECTED GROWTH OF ECONOMY.

5. ON FISCAL SIDE, SECRETARIAT CONSIDERS THAT IT WOULD NOT BE APPROPRIATE TO PROCEED MUCH FURTHER WITH TAX REDUCTIONS, SINCE THEIR IMPACT ON DEMAND IS DIFFICULT TO PREDICT IN CONDITIONS OF HIGH UNEMPLOYMENT. SELECTIVE INCREASES OF EMPLOYMENT-CREATING PUBLIC EXPENDITURES MIGHT BE PREFERABLE. SECRETARIAT EMPHASIZES THAT MAIN CONSIDERATION IS TO ASSURE SATISFACTORY GENERAL ECONOMIC RECOVERY, AND RECOMMENDS THAT SIZE OF DEFICIT OR WAY IT IS FINANCED SHOULD NOT STAND IN WAY OF THIS OBJECTIVE. IT BELIEVES THAT ANY SHORT-TERM BUILD-UP OF LIQUIDITY COULD BE CORRECTED ONCE SUSTAINABLE RECOVERY OF ACTIVITY HAS BEEN ACHIEVED. IN GENERAL TERMS, SECRETARIAT NOTES THAT BOTH MONETARY AND FISCAL POLICIES ARE SUBJECT TO TIME LAGS BEFORE THEY CAN INFLUENCE DEMAND, AND NOTES THAT IT IS PARTICULARLY IMPORTANT TO CONTINUE SEARCHING FOR MORE FLEXIBLE INSTRUMENTS OF DEMAND MANAGEMENT THAN THOSE PRESENTLY AVAILABLE.

6. BALANCE OF PAYMENTS: SECRETARIAT EXPECTS CURRENT ACCOUNT TO SHOW SURPLUS OF \$3.5 BILLION FOR 1975 AS WHOLE, BUT THIS WILL BE CONCENTRATED IN FIRST HALF OF YEAR AND THERE WILL BE APPROXIMATE BALANCE DURING SECOND HALF. SECRETARIAT ANTICIPATES DETERIORATION OF CURRENT ACCOUNT AS RECOVERY GATHERS STEAM AND DEMAND FOR IMPORTS BEGINS TO INCREASE. FOR FULL YEAR LIMITED OFFICIAL USE

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PAGE 03 OECD P 15139 02 OF 03 121424Z

1975, IT FORECASTS EXPORT VOLUMES TO DECLINE BY 1 PERCENT, WHILE IMPORTS DECLINE BY 8.1 PERCENT. SECRETARIAT SEES MILD DETERIORATION IN TERMS OF TRADE DUE MAINLY TO FALLING AGRICULTURAL PRICES.

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PAGE 01 OECD P 15139 03 OF 03 121421Z

44

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LIMITED OFFICIAL USE SECTION 03 OF 03 OECD PARIS 15139

7. MAIN ISSUES FOR DISCUSSION AT ANNUAL REVIEW:

(A) U.S. DELEGATION WILL BE ASKED FOR OFFICIAL VIEWS ABOUT PROBABLE DEVELOPMENTS OF DEMAND, OUTPUT, EMPLOYMENT, AND PRICES DURING NEXT 12 TO 18 MONTHS. IN PARTICULAR, WHETHER STIMULUS IMPARTED TO DEMAND BY PRESENT POLICIES MAY DISAPPEAR BEFORE RECOVERY HAS BECOME SELF-SUSTAINING.

(B) ON MONETARY POLICY, U.S. WILL BE ASKED TO COMMENT ON DOMESTIC IMPLICATIONS OF PRESENT MONETARY STANCE AND APPROPRIATE POSTURE (PARTICULARLY WITH REGARD TO TARGETS FOR GROWTH OF M-1) FOR ALLOWING CYCLICALLY LARGE BUDGET DEFICIT TO BE FINANCED WITHOUT INHIBITING UPSWING OF PRIVATE DEMAND.

(C) ON FISCAL POLICY, U.S. DELEGATION SHOULD BE PREPARED TO COMMENT ON SECRETARIAT JUDGMENT THAT SELEC-  
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PAGE 02 OECD P 15139 03 OF 03 121421Z

TIVE INCREASES IN EMPLOYMENT-CREATING PUBLIC EXPENDI-  
TURES WOULD BE PREFERABLE TO FURTHER TAX REDUCTION, AND  
TO INFORM COMMITTEE OF ANY SPECIFIC MEASURES NOW UNDER  
CONSIDERATION. IN ADDITION, U.S. WILL BE ASKED TO  
COMMENT ON PROBABLE DEVELOPMENTS IN FIELD OF ENERGY  
POLICY AND LIKELY EFFECT ON PRICES AND REAL DEMAND OF

MEASURES BEING CONSIDERED.

(D) ON BALANCE OF PAYMENTS, U.S. DELEGATION WILL BE ASKED TO COMMENT ON RECENT MOVEMENTS IN EXCHANGE RATES AND CAPITAL FLOWS AND ROLE OF INTEREST RATE DIFFERENTIALS; ALSO ON POSSIBILITY THAT INTEREST RATES MAY SHIFT IN FAVOR OF U.S. AND CONTRIBUTE TO REVERSAL OF DOWNWARD PRESSURE ON DOLLAR. IN RELATED QUESTION, U.S. WILL BE ASKED REGARDING INTERNATIONAL CONSIDERATIONS AFFECTING FORMULATION OF MONETARY POLICY.  
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